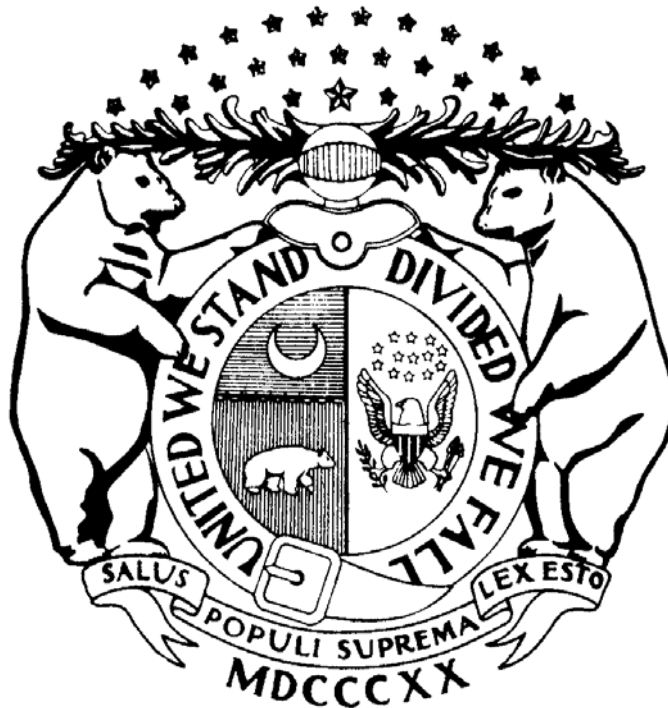


REPORT OF
ASSOCIATION FINANCIAL EXAMINATION

ARCH INSURANCE COMPANY

AS OF
DECEMBER 31, 2002



STATE OF MISSOURI
DEPARTMENT OF INSURANCE
JEFFERSON CITY, MISSOURI

TABLE OF CONTENTS

SCOPE OF EXAMINATION.....	2
PERIOD COVERED.....	2
PROCEDURES.....	2
COMMENTS-PREVIOUS EXAMINATION	3
HISTORY	11
GENERAL.....	11
CAPITAL STOCK	13
DIVIDENDS	13
MANAGEMENT	13
CONFLICT OF INTEREST	15
CORPORATE RECORDS.....	15
ACQUISITIONS, MERGERS AND MAJOR CORPORATE EVENTS.....	16
SURPLUS DEBENTURES.....	16
AFFILIATED COMPANIES.....	16
HOLDING COMPANY, SUBSIDIARIES AND AFFILIATES	16
ORGANIZATIONAL CHART	17
INTERCOMPANY TRANSACTIONS	19
FIDELITY BOND AND OTHER INSURANCE.....	22
PENSION, STOCK OWNERSHIP AND INSURANCE PLANS	23
STATUTORY DEPOSITS	23
DEPOSITS WITH THE STATE OF MISSOURI.....	23
DEPOSITS WITH OTHER STATES AND TERRITORIES.....	23
DEPOSITS WITH THE DEPARTMENT OF LABOR.....	24
DEPOSITS FOR ASSUMED REINSURANCE.....	24

INSURANCE PRODUCTS AND RELATED PRACTICES.....	25
TERRITORY AND PLAN OF OPERATIONS.....	25
POLICY FORMS AND UNDERWRITING	28
ADVERTISING & SALES MATERIAL	28
TREATMENT OF POLICYHOLDERS	28
REINSURANCE.....	28
GENERAL.....	28
ASSUMED	29
CEDED.....	29
ACCOUNTS AND RECORDS.....	34
FINANCIAL STATEMENTS	36
ASSETS	37
LIABILITIES, SURPLUS AND OTHER FUNDS	38
STATEMENT OF INCOME	39
CAPITAL AND SURPLUS ACCOUNT.....	40
NOTES TO THE FINANCIAL STATEMENTS.....	41
EXAMINATION CHANGES.....	41
GENERAL COMMENTS AND/OR RECOMMENDATIONS	41
SUBSEQUENT EVENTS	44
ACKNOWLEDGMENT.....	47
VERIFICATION	47
SUPERVISION.....	47

New York, New York
February 19, 2004

Honorable Alfred W. Gross, Commissioner
Virginia Bureau of Insurance
Chairman of Financial Condition (EX4) Subcommittee

Sally McCarty, Commissioner
Indiana Department of Insurance
Midwestern Zone Secretary

Honorable Scott B. Lakin, Director
Missouri Department of Insurance
301 West High Street, Room 530
Jefferson City, Missouri 65101

Sirs and Madam:

In accordance with your financial examination warrant, a full scope association financial examination has been made of the records, affairs and financial condition of

Arch Insurance Company

hereinafter referred to as such, as the "Company" or as "AIC." Its main administrative office is located at One Liberty Plaza, 53rd Floor, New York, New York 10006, telephone number (212) 651-6500. This examination began on June 9, 2003, and concluded on the above date.

SCOPE OF EXAMINATION

Period Covered

The prior comprehensive financial examination of Arch Insurance Company was made as of December 31, 1999, and was conducted by examiners from the State of Missouri representing the Midwestern Zone of the National Association of Insurance Commissioners (NAIC).

The current full scope association financial examination of the Company covers the period from January 1, 2000, through December 31, 2002, and has been conducted by examiners from the State of Missouri representing the Midwestern Zone of the NAIC with no other zones participating.

This examination also included the material transactions and/or events occurring subsequent to the examination date which are noted in this report.

Procedures

This examination was conducted using the guidelines set forth in the Financial Condition Examiners Handbook of the NAIC, except where practices, procedures and applicable regulations of the Missouri Department of Insurance (MDI) and statutes of the State of Missouri prevailed.

The examiners relied upon information supplied by the independent auditor, PricewaterhouseCoopers LLP, of New York, New York, from its audit covering the period from January 1, 2002, through December 31, 2002. This information included, but was not limited to, attorney letters, account analysis information, and internal control evaluations.

Comments-Previous Examination

Listed below are notes, comments, and recommendations of the previous examination report dated as of December 31, 1999, and the subsequent response or action taken by the Company.

Conflict of Interest

Comment: Contrary to its established policies, none of the officers or directors completed a conflict of interest statement for 1998 and three members of the board of directors and/or officers did not complete the conflict of interest statement in 1999. The Company is advised to ensure that all officers and directors complete a conflict of interest statement annually.

Company's Response: The Conflict of Interest statements will be completed to assure that all directors and officers comply and the Company comports with the regulation.

Current Findings: The Company changed its procedure since the prior examination and no longer requires officers and directors to complete annual conflict of interest statements. [See the Conflict of Interest section of this report for more detail.]

Corporate Records

Comment: The Company's board of directors did not acknowledge or approve the financial examination report of the Company by the Missouri Department of Insurance as of December 31, 1996. The Company is advised to have its Board perform this function in the future.

Company's Response: The Company will review and acknowledge the December 31, 1999 examination report at the Board of Directors meeting following its issuance, as required. The Company will also acknowledge all subsequent examination reports.

Current Findings: The minutes of the Board of Directors meetings did not mention the report of the MDI as of December 31, 1999 or many of the Company's significant corporate events. [See the Corporate Records section of this report for more detail.]

Comment: The stock certificate underlying the issued and outstanding shares carries a par value of \$100, which is inconsistent with the par value stated in the Articles of Incorporation as restated and amended. The Company is advised to correct this discrepancy.

Company's Response: The Company has corrected the par value on the stock certificates.

Current Findings: The current examination was unable to verify the correction as the Company was unable to locate its stock book of record or its stock certificates. The Company has stated it will follow-up and resolve this issue.

Comment: Additional inconsistencies were noted during the review of the minutes, including lack of documentation regarding election and removal of some directors, among others. AIC is advised to ensure that changes in the composition of the board of directors and committees are properly documented.

Company's Response: The Company has experienced a number of officer and director changes during the course of the last three years. These changes were primarily

due to the two ownership changes, which occurred during the examination period. The Company will document elections and hold regular meetings.

Current Findings: The minutes of the Board of Directors meetings did not document the approval of many of the Company's significant corporate events, including the election of some of its officers and directors. [See the Corporate Records section of this report for more detail.]

Intercompany Transactions

Comment: The Company did not disclose its related party agreement with Bowring in the notes to the financial statements and the amounts paid were not disclosed in Schedule Y of the annual statements. The Company is directed to do so in the future.

Company's Response: The Notes to the financial statements and Schedule Y will be corrected in future filings.

Current Findings: No material problems were noted with related party agreement disclosure during the current examination.

Comment: The Company did not disclose some payments related to claims processing made to the parent under a service agreement in the Schedule Y of the annual statements. AIC is directed to report all payments made under service agreements in the Schedule Y of the annual statements.

Company's Response: This occurred because such payments are made separately from payments for all other services provided by FAFC. Accounting staff and management will take measures to make disclosures in future filings.

Current Findings: No material problems were noted with related party agreement disclosure during the current examination.

Comment: As of the examination date, AIC has transactions with an affiliate, First American Service Corporation, that are deemed intercompany transactions without an underlying agreement. The Company is directed to execute an agreement and file same with the Director of the MDI in accordance with Missouri Law.

Company's Response: First American Service Corporation acts as attorney-in-fact for lenders in the establishment and management of GAP Waiver programs. In that capacity, it delivers the lender's premium for a reimbursement contract between the Lender and FAIC. It is a service to the lender. Since there is an affiliation with FAIC, we are in the process of preparing a service agreement describing the relationship between First American Service Corporation and FAIC. The agreement will be submitted to the Department in a Form D filing.

Current Findings: The agreement in question was submitted to the MDI and such agreement was not disapproved.

Reinsurance

Comment: The Company utilizes the services of a related party reinsurance intermediary. The underlying agreement has not being filed with the MDI. The Company was in the process of filing this agreement with the MDI during the course of this examination.

Company's Response: A Form D filing has been made with the Missouri Department of Insurance reflecting the relationship with Guy Carpenter & Company, Inc. The Form D includes the intermediary agreement pursuant to Missouri law, which was signed in 1999. We have been advised that the MDI has no intention of disapproving our filing.

Current Findings: No related party intermediaries were noted during the current examination.

Comment: The Company entered into six facultative agreements during 1999. Each of these agreements does not contain an insolvency clause. The Company is directed to include an insolvency clause in every reinsurance agreement.

Company's Response: The Company will assure that all reinsurance contracts contain an insolvency clause. While all but one of the six facultative agreements are no longer in effect, the Company has taken steps to correct the agreements to reflect appropriate insolvency language.

Current Findings: Problems were noted with unacceptable insolvency clauses during the current examination. [See the Reinsurance section of this report for additional detail.]

Comment: Insolvency clauses contained in several of the reinsurance agreements entered into during the examination period were not in compliance with Missouri Regulation 20 CSR 200 – 2.100(11)(A) (Credit for Reinsurance). The insolvency clause in these agreements contained cut-through language, which is inconsistent with Missouri statutes. The Company is directed to comply with all Missouri Laws and Regulations with respect to reinsurance agreements.

Company's Response: The Company is taking actions to correct all inforce reinsurance contracts to comply with Missouri Regulation 20 CSR 200 – 2.100(11)(A) (Credit for Reinsurance). All “cut-through” language will be eliminated.

Current Findings: Problems were noted with unacceptable insolvency clauses during the current examination. [See the Reinsurance section of this report for additional detail.]

Accounts and Records

Comment: The Company violated Missouri Regulation 20 CSR 200-4.010 (4) (Time Limits) which stipulates that an insurer shall provide, within five (5) working days, any records requested by financial examiners during on-site financial examination. The Company is directed to abide by this Regulation during future examinations

Company's Response: The Company will assure response within the five (5) working days specified by Missouri Regulation 20 CSR 200-4.010 (4) (Time Limits).

Current Findings: Some problems with receiving information timely were still experienced during the current examination. [See the Accounts and Records section of this report for additional detail.]

Comment: During the course of this examination, it was noted that various supporting schedules and/or documentation necessary to obtain regulatory assurance regarding the Company's financial position were not readily available. This is contrary to Missouri Regulation 20 CSR 200-4.010 (Books, Records and Vouchers). The Company is directed to retain all records and/or documentation during future examinations.

Company's Response: The Company will retain all records as required by Missouri Regulation 20 CSR 200-4.010 (Books, Records and Vouchers).

Current Findings: Some problems with receiving information timely were still experienced during the current examination, partially due to the Company's failure to

maintain supporting documentation for information reported on its statutory financial statements. [See the Accounts and Records section of this report for additional detail.]

Comment: Overall, the Company is directed to improve its financial reporting environment and to at all times, ensure that amounts reported in the annual statement line items meet the statutory definition consistent with Missouri Laws and Regulations and the NAIC's Annual Statement Instructions Manual and its Accounting Practices and Procedures Manual.

Company's Response: FAIC is upgrading its financial and accounting staff as well as systems to comply with Missouri Laws and Regulations, the NAIC's Annual Statement Instruction Manual and its Accounting Practices and Procedures Manual.

Current Findings: No significant problems were noted with misclassifications during the current examination.

Comment: The Company is directed to implement procedures for tracking unclaimed property funds. The Company is further advised to reclassify all such funds into aggregate write-ins for liabilities-unclaimed property, and forward such funds to the affected states in accordance with the applicable laws of such states.

Company's Response: The Company is implementing tracking procedures to assure compliance with regulations of affected states.

Current Findings: Problems were still noted with unclaimed property during the current examination. [See the Accounts and Records section of this report for additional detail.]

Financial Statements

Comment: Several differences to the financial statements were found during the examination which were considered to be immaterial on an individual basis but may be material on an aggregate basis. AIC's management should address each difference and resolve the underlying problems as communicated to the Company.

Company's Response: Management is addressing the differences and is resolving the issues raised in the examination report. Management believes the net differences are less than 2% of surplus on an aggregate basis.

Current Findings: Some differences were noted in the current examination but they did not appear to be material on an individual or aggregate basis. Therefore, no comment is included in the current examination report regarding these differences.

Comment: The Company should write-off any account balance that is not supportable by evidentiary matter or any account balance and/or offset that is statutorily not admissible due to passage of time. A similar comment was included in the last examination report of the Company.

Company's Response: The Company is reviewing all account balances and will write-off all balances that are unsupported or are not statutorily admissible due to the passage of time.

Current Findings: Although in some cases there was a considerable delay in obtaining supporting detail, no significant problems were noted in the current examination with balances for which the Company was not ultimately able to provide support.

Subsequent Events

Comment: The Company entered into a reinsurance contract with a related party, Alternative Re Ltd, a Bermuda Company without MDI's approval as required by Missouri Law. The Company is advised to obtain the required approval prior to ceding any business under the agreement.

Company's Response: A Form D filing was presented to the Missouri Department of Insurance on April 4, 2000. The MDI approval has been received.

Current Findings: The agreement in question was submitted to the MDI and was not disapproved.

HISTORY

General

Arch Insurance Company (AIC) (formerly known as First American Insurance Company) was incorporated on December 15, 1971, as a stock casualty insurance company, and was granted authority pursuant to the provisions of Missouri Law at Chapter 379 to commence the business of insurance effective June 30, 1980. AIC was incorporated as a wholly-owned subsidiary of First American Financial Corporation (FAFC). Prior to July 1998, FAFC was collectively owned by Risk Capital Reinsurance Company (Risk Cap), Thornton Cooke II, an individual, and Edward A. Wiegner, also an individual, among others.

On June 30, 1998, The Trident Partnership, LP, an offshore investment company managed by a subsidiary of Marsh & McLennan Companies (MMC), purchased 60.6% of FAFC and the Company (as FAFC's wholly owned subsidiary), with Risk Cap constituting the primary minority shareholder.

Effective July 13, 1999, 100% of the stock of FAFC was acquired by Altus Holdings, Limited (Altus) pursuant to an agreement and plan of merger. Altus, a Cayman Islands holding company, was owned 67.4% by The Trident Partnership, LP, through Tryco II Limited, 28.8% by Risk Capital Reinsurance Company, 3.4% by Marsh & McLennan Risk Capital Holdings Limited, and 0.4% by management. Effective September 20, 2000, MDI approved the transfer of ownership of FAFC from Altus to its subsidiary, Alternative Re, Ltd. The transfer was completed as of October 1, 2000.

On June 4, 2001, the MDI approved the acquisition of FAFC and the Company by Arch Capital Group, Ltd (ACGL). In February 2002, ACGL acquired Rock River Insurance Company (RRIC), domiciled in Wisconsin. In April 2002, the MDI approved the acquisition (through a capital contribution of its parent) of RRIC by AIC, as well as the acquisition (through a capital contribution of its parent) of RRIC's affiliate, Cross River Insurance Company (CRIC). Arch Insurance Company's parent also contributed \$179.3 million (primarily in securities) to AIC as part of this transaction.

In 2002, the name of First American Financial Corporation was changed to Arch Insurance Group Inc. On June 26, 2002, the MDI approved the name change of First American Insurance Company to Arch Insurance Company. In August 2002, RRIC was renamed Arch Specialty Insurance Company and CRIC was renamed Arch Excess & Surplus Insurance Company.

Capital Stock

Arch Insurance Company is one hundred percent (100%) owned by the Arch Insurance Group Inc. (formerly known as First American Financial Corporation). As of December 31, 2002, the Company had authority to issue 20,000 shares of \$250 par value common stock. All of the 20,000 shares were issued and outstanding for a balance of \$5,000,000 in the Company's capital stock account at December 31, 2002.

Dividends

No dividends were declared or paid during the period under examination.

Management

The Directors of Arch Insurance Company elected and serving as of December 31, 2002, were as follows:

<u>Name and Address</u>	<u>Business Affiliation</u>
Thomas L. Gamble Rye Brook, NY	Executive Vice President Arch Insurance Group Inc. and its subsidiaries
Paul B. Ingrey ¹ Palm Coast, FL	Chairman Arch Reinsurance Ltd.
Constantine P. Iordanou ² Upper Brookville, NY	President & Chief Executive Officer Arch Insurance Group Inc. and its subsidiaries
Thomas G. Kaiser New York, NY	Executive Vice President Arch Insurance Group Inc. and its subsidiaries
David G. May Darien, CT	Executive Vice President Arch Insurance Group Inc. and its subsidiaries
Michael R. Murphy Short Hills, NJ	Executive Vice President Arch Insurance Group Inc. and its subsidiaries
Steven D. Nelson Eagan, MN	Executive Vice President Arch Insurance Group Inc. and its subsidiaries
John M. Tetro ³ Rockville Centre, NY	Senior Vice President Arch Insurance Group Inc. and its subsidiaries

Elaine A Trischetta
New York, NY

Executive Vice President
Arch Insurance Group Inc. and its subsidiaries

¹ Effective October 1, 2003, Mr. Ingrey resigned as a board member of AIC and was replaced by Mark D. Lyons, Executive Vice President.

² Effective August 1, 2003, Mr. Iordanou resigned as a board member of AIC and was replaced by Ralph E. Jones III, President and Chief Executive Officer. Mr. Iordanou is now President and Chief Executive Officer of Arch Capital Group Ltd.

³ Effective March 10, 2003, Mr. Tetro was removed as a board member of AIC and replaced by Fred S. Eichler, Senior Vice President and Chief Financial Officer.

Pursuant to its amended and restated Bylaws, the Board of Directors may designate the following committees: Administrative, Audit, Human Resources, and Investment. As of December 31, 2002, the Board of Directors had no active committees.

The officers elected and serving as of December 31, 2002, were as follows:

<u>Name</u>	<u>Title</u>
Constantine P. Iordanou ⁴	President and Chief Executive Officer
Thomas G. Kaiser	President - Property, Energy & Marine Division
Ellen Darrigrand	Executive Vice President
Gary R. Dittman	Executive Vice President
John S. Edack	Executive Vice President
Thomas L. Gamble	Executive Vice President
Mark D. Lyons	Executive Vice President
David G. May	Executive Vice President
John P. Mentz	Executive Vice President
Michael R. Murphy	Executive Vice President
Steven D. Nelson	Executive Vice President
Elaine A. Trischetta	Executive Vice President
Mark G. Wade	Executive Vice President
John M. Tetro	Senior Vice President and Chief Financial Officer
Martin J. Nilsen	Senior Vice President and General Counsel ⁵
Ramin Taraz	Vice President and Controller
Joseph S. Labell	Vice President and Secretary ⁵

⁴ Effective July 1, 2003, Mr. Iordanou resigned as the President and Chief Executive Officer of AIC and was replaced by Ralph E. Jones III. Mr. Iordanou is now President and Chief Executive Officer of Arch Capital Group Ltd.

⁵ Effective May 15, 2003, Mr. Nilsen took over as Secretary from Mr. Labell.

Conflict of Interest

The Company has a “Code of Business Conduct” which contains a “Conflict of Interest” section. The Company requires all employees to sign a one-time “Certificate of Compliance” statement whereby the employees acknowledge receipt and understanding of the “Code of Business Conduct.” The certificates of compliance were reviewed for the directors and top officers. Although “Code of Business Conduct” prohibits conflicts of interest, the Company should institute procedures for its officers and directors requiring them to complete a conflict of interest statement annually. These annual statements should require the officers and directors to answer a series of questions regarding possible areas of conflict rather than the current form which only requires acknowledgement of the code.

Corporate Records

A review was made of the Articles of Incorporation and Bylaws for the period under examination. The Bylaws were last amended and restated as of July 1, 2002, to reflect the name change to Arch Insurance Company; however, the Company was in the process of amending its Bylaws at the end of the examination. Since the prior examination, the Articles of Incorporation were amended only to reflect the name change to Arch Insurance Company.

The minutes of the Company’s Stockholder and Board of Directors meetings were reviewed. No discussion or approval was noted in the minutes for many significant corporate transactions and events and a number of deficiencies were noted. Specifically, the following were not documented in the minutes: the election of some top officers and directors; the discussion and approval of investment decisions for 2002; and the

discussion and approval of significant contracts and changes in corporate direction. The Company did review, ratify and approve many of the noted items in an Unanimous Written Consent of the Board of Directors dated June 3, 2003. The Company should ensure future minutes document the discussion and approval of all significant corporate decisions and events contemporaneously.

Acquisitions, Mergers and Major Corporate Events

In 2001, the Company and its immediate parent were acquired by Arch Capital Group, Ltd. [See the General History section of this report for more details.]

Surplus Debentures

None.

AFFILIATED COMPANIES

Holding Company, Subsidiaries and Affiliates

Arch Insurance Company (AIC) is a member of an insurance holding company system as defined by RSMo Section 382.010 (Definitions). As of December 31, 2002, AIC was the sole owner of Arch Specialty Insurance Company, Arch Excess & Surplus Insurance Company, and First American General Agency, Inc. Arch Specialty Insurance Company (ASIC) is a Wisconsin-domiciled excess and surplus lines insurer approved in 46 states and the District of Columbia. Arch Excess & Surplus Insurance Company (AESIC) is a Nebraska-domiciled excess and surplus lines insurer approved in 23 states and the District of Columbia. First American General Agency, Inc. is an insurance agency incorporated in Texas.

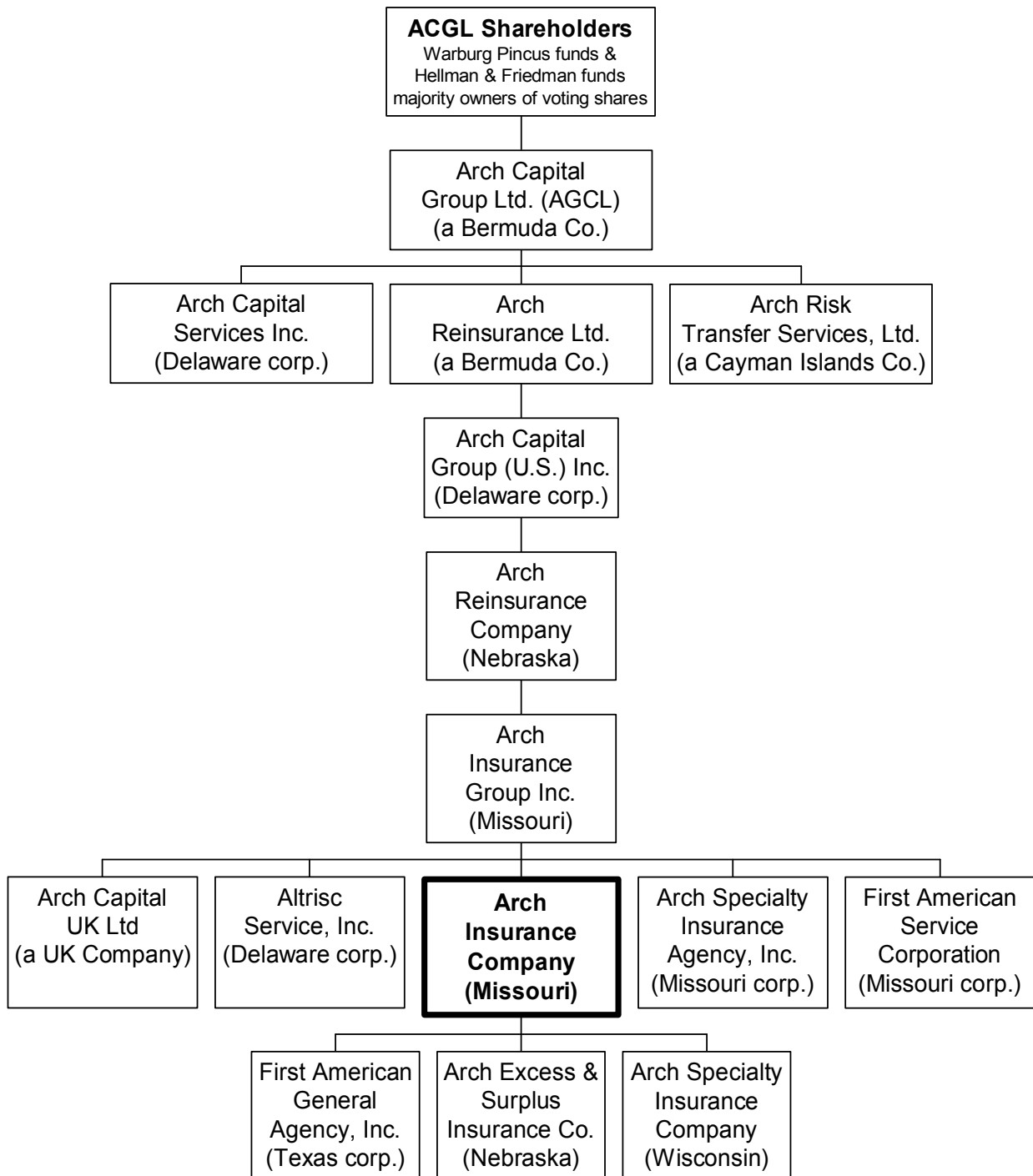
Arch Insurance Company is a wholly owned subsidiary of Arch Insurance Group Inc. (AIG) (formerly known as First American Financial Corporation). AIG is ultimately owned by Arch Capital Group Ltd. (ACGL), a Bermuda-based publicly held limited liability company. ACGL is a holding company whose assets primarily consist of its investments in subsidiaries. ACGL provides insurance and reinsurance on a worldwide basis through its wholly owned subsidiaries in Bermuda and the United States.

AGCL is a publicly-held company traded on the NASDAQ National Market under the symbol AGCL. As of December 31, 2002, there were 27,725,334 shares of AGCL common stock outstanding and 38,844,665 shares of Series A convertible preference shares outstanding. (Preference shares are convertible to common shares at the option of the holder and vote, with common shares, on an as-converted basis.) The Warburg Pincus funds and the Hellman & Friedman funds together own a majority of the voting shares of AGCL (34.3% and 21.5%, respectively), and these shareholders have the right to nominate a majority (six and three directors, respectively) of the AGCL board.

Arch Insurance Company filed Insurance Holding Company System Registration Statements with the State of Missouri annually during the examination period on its own behalf.

Organizational Chart

The following organizational chart depicts the applicable portion of the holding company group, including AIC as of December 31, 2002:



Intercompany Transactions

The Company entered into various intercompany agreements including:

1. Type: First Amended Service Agreement

Parties: AIC and Arch Insurance Group Inc. (AIG), AIC's parent

Effective: July 1, 1999. This agreement superseded similar agreements in effect dating back to 1985.

Terms: AIG ("the Parent") shall provide the Company with supervision of all phases of its operations, including, but not limited to, the following: underwriting, actuarial studies, claims service, accounting, data processing, and other responsibilities. For the services provided, AIG shall be compensated no more than the costs it incurred in providing said services. AIG shall submit a bill to the Company covering the time period for which compensation is sought. The agreement further provides that AIG "reserves the right to charge the Company a lesser amount than the Parent's actual costs, and any such difference in charges may not be recovered by the Parent at a later time."

Exam Exception: Included in the expenses for which AIG is charging AIC are fees from affiliates. Some of these fees are on a "cost plus" basis whereby a profit margin is added. AIC should either execute separate agreements with these affiliates or amend the agreement with AIG to specifically disclose these fee agreements and the basis for the charges from the affiliates. The new agreements with affiliates or the amended agreement with AIG are required to be submitted to MDI pursuant to RSMo Section 382.195.1(4) (Transactions within a holding company system).
2. Type: Services Agreement

Parties: AIC and Altrisc Services, Inc., an affiliate (Altrisc)

Effective: October 1, 1999. (This agreement was terminated in 2000.)

Terms: Altrisc shall provide marketing and administrative assistance in the development of program business. Specific assistance to be provided includes, but is not limited to, contracting with general agents, assistance with the placement of reinsurance, assistance in development and enforcement of underwriting programs, oversight of general agents, arrangements for third party administrators, establishment of data processing systems and accounting. For the

services provided, Altrisc shall be compensated no more than the costs it incurred in providing the said services.

3. Type: Commission Agreement

Parties: AIC and Arch Specialty Insurance Agency, Inc. (ASIA), an affiliate (formerly known as First American Insurance Agency, Inc.)

Effective: November 1, 1997

Terms: AIC will provide services and facilities to allow ASIA to produce business for the Company. ASIA will be paid commission on business produced for the Company, subject to a limit based on the net operating results of ASIA.
4. Type: Commission Agreement

Parties: AIC and First American General Agency, Inc. (FAGA), a subsidiary

Effective: November 1, 1997

Terms: AIC will provide services and facilities to allow FAGA to produce business for the Company. FAGA will be paid commission on business produced for the Company, subject to a limit based on the net operating results of FAGA.
5. Type: Consolidated Federal Income Tax Agreement

Parties: Arch Capital Group (U.S.), Inc. (ACG - US) and Subsidiaries (including AIC)

Effective: January 1, 2002. (Previously, AIC filed a consolidated return with its immediate parent, AIG.)

Terms: Pursuant to the terms of the agreement, the parent collects from, or refunds to, each subsidiary, the amount of taxes or benefits determined as if the subsidiary filed a separate return. The agreement stipulates that balances arising out of the agreement shall be settled no less often than quarterly.
6. Type: Service Agreement

Parties: AIC and First American Service Corporation (FASC)

Effective: November 10, 2000

Terms: FASC agrees to administer an approved GAP Waiver Program, collecting fees from participating Lenders/Lessors, distributing fees to agents representing said Lenders/Lessors, and purchasing insurance protection through AIC. The GAP coverage insures the Lenders/Lessors for the difference between the fair market value of a totaled vehicle and the loan balance on the vehicle. Per the Agreement, FASC is allowed to retain up to \$25 out of the fees collected from Lenders/Lessors; however, FASC did not retain any fees during the exam period. No compensation is due to FASC from AIC.

Exam Exception: The Company included only the amounts received under this agreement rather than the entire amount paid by the Lenders/Lessors to FASC as premium on AIC's premium tax returns. The Company should consider whether to report the entire fee paid by the Lenders/Lessors to FASC on future premium tax returns and to file amended returns for prior years to correct any deficiency.

Following is a table of the fees incurred (or received) under the above described Arch Insurance Company intercompany agreements (excluding the tax agreement). This table shows the other party to the agreement, the agreement name, and the dollar amount incurred (or received) by AIC under each agreement for 2000, 2001, and 2002:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Arch Insurance Group Inc. -			
First Amended Service Agreement	\$16,595,000	\$2,450,000	\$3,331,360
Altrisc Services, Inc. -			
Service Agreement	NA	NA	1,156,214
Arch Specialty Insurance Agency, Inc. -			
Commission Agreement	800	(183,000)	906,156
First American General Agency -			
Commission Agreement	(117,667)	208,749	(23,123)
First American Service Corporation -			
Service Agreement	<u>NF</u>	<u>NF</u>	<u>NF</u>
Totals	<u>\$16,478,133</u>	<u>\$2,475,749</u>	<u>\$5,370,607</u>

NF = No fees were paid or due to or from AIC under this agreement during the exam period.

NA = Not applicable as this agreement was terminated in 2000 and no fees were paid in 2001 or 2002.

In addition to the intercompany agreements described above, AIC also ceded business to affiliates through reinsurance agreements. These agreements are described in the Reinsurance section of this report.

During the examination period, AIC both received capital contributions and contributed capital to its subsidiary. In 2000, AIC received a capital contribution of \$2,160,849 in securities and accrued interest. In 2002, AIC received capital contributions from its parent totalling \$216,124,996. These contributions included \$12,951,489 in cash, \$166,395,192 in securities and accrued interest, and 100% of the stock in two insurance companies: Arch Specialty Insurance Company for \$16,387,590 and Arch Excess & Surplus Insurance Company for \$20,390,725. Later in 2002, AIC contributed \$34,615,437 in securities and accrued interest as a capital contribution to Arch Specialty Insurance Company, one of AIC's new subsidiaries.

FIDELITY BOND AND OTHER INSURANCE

The Company is a named insured, along with other subsidiaries of Arch Capital Group (U.S.) Inc., on a financial institution bond with a single loss limit of liability of \$10 million, an aggregate loss liability limit of \$20 million, and a \$50,000 single loss deductible. This level of coverage complies with the suggested minimum amount of fidelity insurance according to NAIC guidelines.

The Company is also a named insured on the following insurance policies:

Property and General Liability	Workers Compensation
Umbrella Liability	Directors and Officers Liability
Fiduciary Liability	Commercial Automobile

PENSION, STOCK OWNERSHIP AND INSURANCE PLANS

Arch Insurance Company has no direct employees. Services are provided primarily by affiliates of AIC, as described in the Intercompany Transactions section of this report. The typical employee benefits are available to employees of the Arch holding company system including, but not limited to, pension, 401(k), flexible benefits, health care, dental, short-term and long-term disability, and group life insurance. The expenses for these benefits are charged to AIC through intercompany service fees. Other than any unpaid billings under intercompany agreements at year-end 2002, AIC had no additional liability for the benefits provided.

STATUTORY DEPOSITS

Deposits with the State of Missouri

The funds on deposit with the Missouri Department of Insurance as of December 31, 2002, as reflected below, were sufficient to meet the capital deposit requirements for the State of Missouri in accordance with RSMo Section 379.098 (Insurance other life-Security deposits). The funds on deposit as of December 31, 2002, were as follows:

<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
U.S. Treasury Note	\$2,700,000	\$3,019,788	\$2,856,686

Deposits with Other States and Territories

The Company also has funds on deposit with various other states and a territory in which it is licensed. Those funds on deposit as of December 31, 2002, were as follows:

<u>State or Territory</u>	<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Stmnt Value</u>
Arizona	U.S. Treasury Note	\$110,000	\$126,466	\$109,608
Arkansas	U.S. Treasury Note	300,000	328,968	304,030

California	U.S. Treasury Note	100,000	110,750	99,458
Florida	U.S. Treasury Note	300,000	332,250	298,375
Georgia	U.S. Treasury Note	80,000	87,725	81,075
Louisiana	U.S. Treasury Note	70,000	77,525	69,621
Massachusetts	U.S. Treasury Note	550,000	636,205	595,002
New Mexico	FNMA Note	400,000	453,124	417,240
North Carolina	U.S. Treasury Note	500,000	553,750	497,291
Oregon	U.S. Treasury Note	110,000	121,825	109,404
South Carolina	FNMA Note	125,000	146,250	132,805
Virginia	FNMA Note	300,000	301,693	301,693
Puerto Rico	Commonwealth Bond	<u>300,000</u>	<u>327,547</u>	<u>327,547</u>
Totals		<u>\$3,245,000</u>	<u>\$3,604,078</u>	<u>\$3,343,149</u>

Deposits with the Department of Labor

The Company has funds on deposit required by the Department of Labor with the Federal Reserve Bank of Kansas City. Those funds on deposit as of December 31, 2002, were as follows:

<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Statement Value</u>
U.S. Treasury Note	\$400,000	\$443,000	\$397,833

Deposits for Assumed Reinsurance

In addition, the Company has the following trust and collateral deposits related to assumed reinsurance as of December 31, 2002:

<u>Deposit Holder</u>	<u>Type of Security</u>	<u>Par Value</u>	<u>Fair Value</u>	<u>Stmt Value</u>
Reinsurance Treaty Trust	U.S. Treasury Note	\$176,830	\$176,830	\$176,830
Brown Brothers Harriman	U.S. Treasury Note	<u>883,000</u>	<u>883,000</u>	<u>883,000</u>
Totals		<u>\$1,059,830</u>	<u>\$1,059,830</u>	<u>\$1,059,830</u>

INSURANCE PRODUCTS AND RELATED PRACTICES

Territory and Plan of Operations

Arch Insurance Company is licensed by the Missouri Department of Insurance under RSMo Chapter 379 (Insurance other than life), to write the business of property and casualty. As of December 31, 2002, the Company was licensed in all 50 states, the District of Columbia, and Puerto Rico.

The Company's stated overall strategy is to be highly selective in the risks underwritten and very opportunistic, identifying profitable underserved niches less vulnerable to market cycles to enter while exiting less profitable areas. Writings are through brokers, managing general agents (MGAs), managing general underwriters (MGUs), and general agents. Profit-sharing plans exist with many of the underwriting managers. Actuarial analyses are performed on each new line in order to project loss ratios and rate changes. The producers of these lines are then examined periodically to determine if targets are achieved and if underwriting guidelines are followed.

AIC has three profit centers: Program, Specialty, and Lenders. For the year ending December 31, 2002, seventy percent (70%) of the Company's written premium was Program business, with twenty-two percent (22%) of the writings in the Specialty lines, and eight percent (8%) in the Lenders lines.

AIC's program business is written primarily through its Stamford, CT operations. This business has shifted from the mono-line and single/few state business originally written in 1999 to multi-line covering several states. The line of business profile for policy year 2002 varies by program but can generally be categorized into four lines of

business in order of size: Workers Compensation, Commercial Auto, General Liability, and Property.

AIC's divides its Program business into four categories: Traditional Programs, Alternative Market, Corporate Risk, and Accident & Health. Traditional program business is traditional in structure and coverage. For the 2002 treaty year, AIC retained a much larger segment of this business but for the years both before and after 2002, 90% of this business was generally ceded. Alternative market programs business is similar in coverage to traditional program business but attempts to use more of the financing/risk transfer structures associated with the Corporate Risk business. Corporate Risk programs business utilizes the Arch Capital Group Ltd. internal Bermuda captive, Alternative Re Ltd., in a rent-a-captive structure. The direct policy is written by AIC with the first \$350,000 per occurrence and \$2.5 in the aggregate ceded to Alternative Re Ltd. while being fully collateralized. Accident & health (A&H) programs are medical stop-loss business. The A&H Program book and underwriting personnel joined AIC in mid-year 2002 and began operations thereafter. All of the business written in 2002 was done on an assumed basis as filings were being put in place.

AIC's Specialty business is high excess insurance which AIC began writing in the spring of 2002. Specialty lines consists of casualty, executive assurance, professional liability, healthcare, and property. Casualty business consists of Primary Surplus Lines Casualty, written at mostly \$1 million limits with self-insured retentions employed to eliminate frequency and Miscellaneous Casualty, which includes residential contractors business and employee leasing workers compensation. The Executive Assurance book predominantly includes Directors & Officers liability on a high excess basis.

Professional Liability business bound in 2002 was mostly Lawyers Professional Liability, Architects & Engineers Errors & Omissions (E&O) and what is considered to be “Miscellaneous Professional” classes for Real Estate E&O and Agents E&O. Property business is written on both a primary and excess basis. The largest single component is the McDonald’s program, which started in the fall of 2002 and insures the property exposures related to individual McDonald franchises.

AIC’s lender lines include GAP and Collateral Protection Insurance (CPI). GAP insurance protects lenders of automobile loans, in the event that the loan balance exceeds the actual cash value (ACV) of the vehicle at the time of a total loss to the vehicle. (The lender has waived the borrower’s responsibility to repay the amount of the loan balance in excess of the ACV of the vehicle.) CPI provides automobile physical damage coverage for the lender’s interest in loan collateral, typically the vehicle, in the event that a loss to the vehicle is uninsured. AIC does not reinsure the lender lines.

Discontinued lines include an appliance warranty program, a Missouri non-standard automobile program, a commercial trucking program, and a home warranty program.

AIC has projected both gross and net written premiums for 2003 will be three times the 2002 levels. AIC projects gross written premium for 2004 and 2005 will grow at a more moderate 15 to 20% rate while net written premium is projected to shrink from 2003 to 2004 by half due to significantly higher ceding percentages for the program business.

Policy Forms and Underwriting
Advertising & Sales Material
Treatment of Policyholders

The Missouri Department of Insurance has a market conduct staff which performs a review of these issues and generates a separate market conduct report. The last MDI Market Conduct Examination [Report #2067-1298-PAC] dated March 10, 1999, was reviewed during the prior examination and no material discrepancies were noted. A California Market Conduct Examination was performed as of 2001. This report was reviewed and no problems were noted which would have a material impact on the financial condition of AIC.

REINSURANCE

General

The Company's reinsurance and premium activity during the period under examination are as follows:

<u>Premiums Written:</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>
Direct Business	\$260,762,240	\$93,633,040	\$87,334,557
Reinsurance Assumed:			
Affiliates	0	0	0
Non-Affiliates	33,006,198	1,210,428	209,306
Reinsurance Ceded:			
Affiliates	(114,186,062)	(3,408,316)	(678,684)
Non-Affiliates	<u>(74,388,941)</u>	<u>(68,534,333)</u>	<u>(62,647,459)</u>
Net Premiums Written	<u>\$105,193,435</u>	<u>\$22,900,819</u>	<u>\$24,217,720</u>

Assumed

On April 28, 2002, AIC entered into a quota-share assumption agreement with Combined Specialty Insurance Company, (formerly known as Virginia Surety Company), an Illinois corporation, to assume 65% of all business produced and/or underwritten by the Construction Program Group. The business covered under this agreement included workers compensation, employers liability, general liability, automobile liability, and railroad protective liability. This agreement went into runoff on August 1, 2003. The majority, \$31 million or 95%, of the business assumed by AIC during 2002 was under this agreement with Combined Specialty Insurance Company.

During the review of this agreement, it was noted that the agreement was not executed by AIC; and therefore, was in violation of NAIC Accounting Practices and Procedure Manual Statement of Statutory Accounting Principal 62 (SSAP 62), Property and Casualty Reinsurance. During the course of the examination, the Company executed the agreement. The Company is advised to ensure that all future reinsurance agreements are executed in accordance with SSAP 62.

Ceded

The majority of AIC's 2002 ceded premiums, \$114 million or 61%, was ceded to four of its affiliates, as follows (in descending order of volume): Arch Reinsurance Ltd., Alternative Re Ltd., Arch Reinsurance Company, and Alternative Insurance Company Ltd. In addition, these affiliated reinsurers accounted for \$45 million, or 27%, of the net amount recoverable from reinsurers as of December 31, 2002.

Effective March 1, 2002, the Company entered into a quota-share agreement with Arch Reinsurance Ltd. (Arch Re Ltd), a Bermuda based affiliate. All of the \$60 million

in premiums AIC ceded to Arch Re Ltd in 2002 were under this reinsurance contract. Under the terms of this agreement, the Company cedes 90% of all net retained liability arising from all insurance business undertaken, excluding business produced by certain of the Company's business units, namely the Program, Alternative Market and Lenders policies. Effective January 1, 2003, this agreement was amended to expand the business covered to include AIC's Program business with inception dates or renewal dates on, or after, January 1, 2003. The \$27 million in net amounts recoverable from Arch Re Ltd at December 31, 2002 under this agreement were covered by a trust, since Arch Re Ltd is an unauthorized reinsurer.

Effective March 1, 2002, the Company entered into a quota-share agreement with Arch Reinsurance Company (Arch Re), a Nebraska domiciled affiliate, which accounts for 99% of the \$13 million in premium AIC ceded to Arch Re in 2002. Under the terms of this agreement, the Company cedes 50% of the net retained liability under all policies issued or renewed during the term of the agreement, in connection with business produced by Alternative Transportation Providers Insurance Agency, Inc. This agreement terminated April 30, 2003 and is currently in run-off.

As of December 31, 2002, the Company had nineteen active reinsurance agreements with Alternative Re, Ltd. (Alt Re), a Bermuda affiliate under which AIC ceded \$39 million in 2002 premium. The majority (\$23 million or 60%) of premiums ceded to Alt Re are for thirteen facultative quota-share agreements, termed 'Corporate Risk' agreements by the Company, covering workers compensation or general liability policies written to individual corporations, such as nursing homes, auto dealers, or contractors. Typically, the direct policy is written by AIC, and amounts per occurrence

and in the aggregate, varied by policy, are ceded to Alt Re. As an unauthorized reinsurer, Alt Re has established a clean, irrevocable and unconditional Letter of Credit, with AIC as the beneficiary, for each of the reinsurance agreements in the amount of the net recoverable from Alt Re.

Effective November 1, 2000, the Company entered into a quota-share reinsurance agreement with Knight Insurance Company, Ltd. (Knight), a Grand Cayman insurer. Under this agreement, AIC cedes 100% of the liability for all automobile physical damage and renters liability business administered by Knight Management Insurance Services, LLC, including business assumed by AIC from Underwriters Insurance Company. During 2002, AIC ceded premiums of \$15 million, or 8% of total ceded premium, to Knight under this reinsurance contract. As Knight is an unauthorized reinsurer, it provided a clean, irrevocable and unconditional Letter of Credit to cover the \$7.6 million net recoverable (4% of the total net recoverable) as of December 31, 2002

Effective April 1, 2002, the Company and Arch Specialty Insurance Company (ASIC), a Wisconsin domiciled affiliate, entered into a quota-share reinsurance agreement with Employers Reinsurance Company (ERC). Under this agreement, AIC and ASIC cede 50% of the net retained liability under the following types of contracts: Directors and Officers Liability; Pension Trust Liability/Fiduciary; Employment Practices Liability; Fidelity; General Partner Liability; Real Estate Investment Trust Liability; and various Professional Liability products. The agreement allows policies to be written for up to \$25 million aggregate per product line, with \$5 million ceded to a facultative reinsurer; thereby, limiting ERC's exposure to \$10 million aggregate per product line. During 2002, AIC ceded premiums of \$9 million, or 5% of total ceded

premiums, to ERC under this reinsurance contract, and carried net amounts recoverable of \$4.6 million (5% of the total net recoverable) as of December 31, 2002.

The Company currently has a number of other reinsurance agreements that have been terminated and are now in run-off status. Several of these agreements have significant net amounts recoverable from the reinsurers at December 31, 2002. AIC has quota-share and excess of loss agreements in run-off for workers compensation policies produced and underwritten by Combined Independent Agencies, Inc. (CIA). Hartford Fire Insurance Company (Hartford Fire) and Swiss Reinsurance American Corporation (Swiss Re) were the primary reinsurers for this program. As of December 31, 2002, AIC carried a net amount recoverable from Hartford Fire of \$19 million (or 11% of the total net recoverable from reinsurers), and a net amount recoverable from Swiss Re of nearly \$12 million (7% of the total). AIC has a 90% quota-share agreement with GE Reinsurance Corporation (GE Re) in run-off for trucker's liability policies produced by Sebrite Agency Inc. As of December 31, 2002, AIC carried a net amount recoverable from GE Re of nearly \$9 million (5% of the total net recoverables).

Several of the reinsurance agreements entered into during the examination period contained insolvency clauses which were not in compliance with Missouri Regulation 20 CSR 200-2 (Credit for Reinsurance), including the above described agreements with Alt Re, Knight, Hartford Fire, and Swiss Re. The insolvency clause in these agreements contains "right of offset" language that is inconsistent with Missouri Statutes and therefore unacceptable. The Company is directed to amend all reinsurance agreements containing the unacceptable insolvency clauses or not take credit on future Annual Statements and other statutory filings for any reinsurance agreement which does not fully

comply with Missouri Regulation 20 CSR 200-2 (Credit for Reinsurance), including an acceptable insolvency clause.

Several of the reinsurance agreements entered into by AIC were not executed within nine months after the commencement of the policy period covered by said reinsurance agreements, including the above described agreements with Combined Specialty Insurance Company, Alt Re, Hartford Fire, and Swiss Re. Per the NAIC Accounting Practices and Procedures Manual SSAP 62, Property and Casualty Reinsurance, a reinsurance agreement will be presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement; if, within nine months after the commencement of the policy period covered by the reinsurance arrangement, an agreement entered into, renewed or amended on or after January 1, 1994, has not been finalized, reduced to written form, and signed by the parties. On October 10, 2003, AIC submitted a request for a waiver from retroactive accounting treatment for certain reinsurance agreements identified during the examination as having been signed after said nine month period. On October 31, 2003, the MDI granted AIC's request for a waiver of retroactive accounting treatment only for the reinsurance agreements included in the waiver request. AIC is advised to ensure that in the future, all reinsurance contracts comply with the provisions of SSAP 62.

The Company is contingently liable for all reinsurance losses ceded or retroceded to others. This contingent liability would become an actual liability in the event that an assuming reinsurer fails to perform its obligations under its reinsurance agreement with the Company.

ACCOUNTS AND RECORDS

Although the Company provided documentation to support its Information System (IS) environment, it was not possible to perform detailed testing of the Company's IS control environment as part of the examination since AIC's IS control environment was not in a finished state during the examination period. AIC has a complicated and changing structure involving numerous lines of business, multiple marketing channels, and extensive third party dependencies. AIC and its affiliates are simultaneously implementing several financially significant applications, supporting databases, and data warehouses, while experiencing rapid growth. During the examination period, much of the processing of financial information involved the use of spreadsheets and manual intervention as the supporting applications were being integrated. These conditions increase the risk of errors and misstatements and should be considered a limitation on the results of this examination. The Company should complete its implementation of the new systems and interfaces and ensure the resulting IS and operating environments have strong internal controls and are conducive to reliance upon them for the production of reliable data.

The prior examination noted that the Company failed to provide information to the examiners in a timely manner, which resulted in delays in the examination process. During the current examination, problems still existed regarding the timeliness of some of AIC's responses to MDI examination requests, particularly as related to information requested from third party administrators and managing general agents. AIC is directed to ensure supporting detail is maintained for all financial information submitted in future statutory filings and to devote sufficient resources to ensure that it responds to all future

examination requests in a timely manner in accordance with Missouri Regulation 20 CSR 200-4.010 (4) (Time Limits).

The prior examination directed the Company to implement procedures for tracking unclaimed property funds and ensure such funds were forwarded to the affected states in accordance with the applicable laws of such states. During the current examination period, the Company had not implemented such procedures and was incorrectly voiding drafts which were not offers of settlement. In October 1, 2003, Arch Insurance Group Inc., on behalf of AIC and its other subsidiaries, did establish an Abandoned Property Committee tasked with ensuring the companies within AIC account for and report unclaimed property in compliance with applicable state laws. The Company should ensure that the appropriate procedures and controls are implemented and review drafts voided in the past by AIC and escheat any which were not offers of settlement.

Financial statements of the Company were audited by the CPA firm PricewaterhouseCoopers LLP, of New York, New York, for the years ending December 31, 2002 and 2001. Financial statements of the Company for the year ending December 31, 2000 were audited by the CPA firm, Deloitte & Touche LLP, of New York, New York.

Loss reserves of the Company were reviewed and certified as of December 31, 2002 by Mark D. Lyons, ACAS, MAAA, Executive Vice President and Chief Actuary of Arch Insurance Group Inc., AIC's parent. Loss reserves of the Company were reviewed and certified by Jeff Carlson, FCAS, MAAA, with Tillinghast-Towers Perrin, of Weatogue, Connecticut for the years ending December 31, 2001, and 2000.

FINANCIAL STATEMENTS

The following financial statements, with supporting exhibits, present the financial condition of the Company for the period ending December 31, 2002. Any examination adjustments to the amount reported in the Annual Statement and/or comments regarding such are made in the “Notes to the Financial Statements”. (The failure of any column of numbers to add to its respective total is due to rounding or truncation.)

There may have been differences found in the course of this examination, which are not shown in the “Notes to the Financial Statements”. These differences were determined to be immaterial, concerning their effect on the financial statements. Therefore they were communicated to the Company and/or noted in the workpapers for each individual Annual Statement item.

Assets

	<u>ASSETS</u>	<u>ASSETS NOT ADMITTED</u>	<u>NET ADMITTED ASSETS</u>
Bonds	\$236,998,302		\$236,998,302
Common stocks	71,438,946	\$355,469	71,083,477
Cash and short-term investments	60,818,480		60,818,480
Agents' balances or uncollected premium	57,302,399	689,747	56,612,652
Funds held by or deposited with reinsured companies	430,367		430,367
Reinsurance recoverable on loss and loss adjustment expense payments	11,446,477		11,446,477
Federal income tax recoverable	5,621,000	945,000	4,676,000
Electronic data processing equipment	115,653		115,653
Interest, dividends and real estate income due and accrued	2,979,978		2,979,978
Receivable from parent, subsidiaries and affiliates	11,223,991		11,223,991
Other assets nonadmitted	677,163	677,163	0
Aggregate write-ins for other than invested assets:			
Claim deposits	2,959,367		2,959,367
Refunded rent deposit receivable	<u>943,600</u>	<u>0</u>	<u>943,600</u>
Total Assets	<u>\$462,955,723</u>	<u>\$2,667,379</u>	<u>\$460,288,344</u>

Liabilities, Surplus and Other Funds

Losses	\$19,865,903
Reinsurance payable on paid loss and loss adjustment expenses	
Loss adjustment expenses	5,245,046
Contingent commissions and other similar charges	2,376,801
Other expenses	261,747
Taxes, licenses and fees (excluding federal and foreign income taxes)	5,214,422
Unearned premiums	66,818,592
Ceded reinsurance premiums payable (net of ceding commissions)	78,507,451
Funds held by company under reinsurance treaties	275,815
Amounts withheld or retained by company for account of others	1,740,510
Provision for reinsurance	2,271,482
Drafts outstanding	2,898,954
Payable to parent, subsidiaries and affiliates	6,634,133
Payable for securities	<u>20,427,431</u>
Total Liabilities	\$212,538,287
Common capital stock	5,000,000
Gross paid in and contributed surplus	239,468,390
Unassigned funds (surplus)	<u>3,281,667</u>
Surplus as regards policyholders	<u>\$247,750,057</u>
TOTAL LIABILITIES AND NET WORTH	<u>\$460,288,344</u>

Statement of Income

Underwriting Income

Premiums earned	\$54,003,205
-----------------	--------------

Deductions

Losses incurred	\$30,166,071
-----------------	--------------

Loss expenses incurred	7,586,237
------------------------	-----------

Other underwriting expenses incurred	<u>30,851,086</u>
--------------------------------------	-------------------

Total underwriting deductions	<u>\$68,603,394</u>
-------------------------------	---------------------

Net underwriting gain/(loss)	(\$14,600,189)
-------------------------------------	----------------

Investment Income

Net investment income earned	\$7,080,640
------------------------------	-------------

Net realized capital gains or (losses)	<u>77,792</u>
--	---------------

Net investment gain or (loss)	\$7,158,432
--------------------------------------	-------------

Other Income

Net gain or (loss) from agents' or premium balances charged off	\$(78,073)
---	------------

Finance and service charges not included in premiums	96,550
--	--------

Miscellaneous other income	<u>(252,720)</u>
----------------------------	------------------

Total other income	(\$234,243)
---------------------------	-------------

Net income before dividends to policyholders and federal income taxes	(\$7,676,000)
---	---------------

Federal and foreign income taxes incurred	<u>1,687,794</u>
---	------------------

Net income (loss)	<u>(\$9,363,794)</u>
--------------------------	----------------------

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2001	\$38,633,323
Net income	(9,363,794)
Net unrealized capital gains or (losses)	(310,276)
Change in net deferred income tax	4,375,000
Change in nonadmitted assets	488,290
Change in provision for reinsurance	(2,197,482)
Capital changes:	
Paid in	<u>216,124,996</u>
Net change in surplus as regards policyholders for the year	<u>\$209,116,734</u>
Surplus as regards policyholders, December 31, 2002	<u>\$247,750,057</u>

NOTES TO THE FINANCIAL STATEMENTS

None

EXAMINATION CHANGES

None

GENERAL COMMENTS AND/OR RECOMMENDATIONS

Conflict of Interest (Page 14)

Although the Company's "Code of Business Conduct" prohibits conflicts of interest, the Company should institute procedures for its officers and directors requiring them to complete a conflict of interest statement annually. These annual statements should require the officers and directors to answer a series of questions regarding possible areas of conflict rather than the current form which only requires acknowledgement of the code.

Corporate Records (Page 15)

No discussion or approval was noted in the minutes of the Company's Stockholder and Board of Directors meetings for many significant corporate transactions and events and a number of deficiencies were noted. Specifically, the following were not documented in the minutes: the election of some top officers and directors; the discussion and approval of investment decisions for 2002; and the discussion and approval of significant contracts and changes in corporate direction. The Company did review, ratify and approve many of the noted items in an Unanimous Written Consent of the Board of Directors dated June 3, 2003. The Company should ensure future minutes document the

discussion and approval of all significant corporate decisions and events contemporaneously.

Intercompany Transactions (Page 19)

Included in the expenses for which AIG charges AIC under a Service Agreement are fees from affiliates. Some of these fees are on a “cost plus” basis whereby a profit margin is added. AIC should either execute separate agreements with these affiliates or amend the agreement with AIG to specifically disclose these fee agreements and the basis for the charges from the affiliates. The new agreements with affiliates or the amended agreement with AIG are required to be submitted to MDI pursuant to RSMo Section 382.195.1(4) (Transactions within a holding company system).

Intercompany Transactions (Page 20)

AIC receives premium for a GAP Waiver Program from FASC under a Service Agreement. AIC included only the amounts received under this agreement rather than the entire amount paid by the Lenders/Lessors to FASC as premium on AIC’s premium tax returns. The Company should consider whether to report the entire fee paid by the Lenders/Lessors to FASC on future premium tax returns and to file amended returns for prior years to correct any deficiency.

Reinsurance (Page 32)

Several of the reinsurance agreements entered into during the examination period contained insolvency clauses which were not in compliance with Missouri Regulation 20 CSR 200-2 (Credit for Reinsurance), including the above described agreements with Alt Re, Knight, Hartford Fire, and Swiss Re. The insolvency clause in these agreements contains “right of offset” language that is inconsistent with Missouri Statutes and

therefore unacceptable. The Company is directed to amend all reinsurance agreements containing the unacceptable insolvency clauses or not take credit on future Annual Statements and other statutory filings for any reinsurance agreement which does not fully comply with Missouri Regulation 20 CSR 200-2 (Credit for Reinsurance), including an acceptable insolvency clause.

Reinsurance (Page 33)

Several of the reinsurance agreements entered into by AIC were not executed within nine months after the commencement of the policy period covered by said reinsurance agreements. Per the NAIC Accounting Practices and Procedures Manual SSAP 62, Property and Casualty Reinsurance, a reinsurance agreement will be presumed to be retroactive and shall be accounted for as a retroactive reinsurance agreement; if, within nine months after the commencement of the policy period covered by the reinsurance arrangement, an agreement entered into, renewed or amended on or after January 1, 1994, has not been finalized, reduced to written form, and signed by the parties. AIC is advised to ensure that in the future, all reinsurance contracts comply with the provisions of SSAP 62.

Accounts and Records (Page 34)

AIC and its affiliates are simultaneously implementing several financially significant applications, supporting databases, and data warehouses, while experiencing rapid growth. During the examination period, much of the processing of financial information involved the use of spreadsheets and manual intervention as the supporting applications were being integrated. These conditions increase the risk of errors and misstatements. The Company should complete its implementation of the new systems

and interfaces and ensure the resulting IS and operating environments have strong internal controls and are conducive to reliance upon them for the production of reliable data.

Accounts and Records (Page 34)

During the current examination, problems still existed regarding the timeliness of some of AIC's responses to MDI examination requests, particularly as related to information requested from third party administrators and managing general agents. AIC is directed to ensure supporting detail is maintained for all financial information submitted in future statutory filings and to devote sufficient resources to ensure that it responds to all future examination requests in a timely manner in accordance with Missouri Regulation 20 CSR 200-4.010 (4) (Time Limits).

Accounts and Records (Page 35)

During the current examination period, the Company had not implemented unclaimed property procedures and was incorrectly voiding drafts which were not offers of settlement. In October 1, 2003, Arch Insurance Group Inc., on behalf of AIC and its other subsidiaries, did establish an Abandoned Property Committee tasked with ensuring the companies within AIC account for and report unclaimed property in compliance with applicable state laws. The Company should ensure that the appropriate procedures and controls are implemented and review drafts voided in the past by AIC and escheat any which were not offers of settlement.

SUBSEQUENT EVENTS

In a July 1, 2003 Resolution of the AIC Board of Directors, the Company resolved, subject to regulatory approval from the Missouri Department of Insurance, to

accept a contribution of capital from its parent, AIG, consisting of all the shares of the common stock of Western Diversified Casualty Insurance Company. As of the date of this examination report, this proposed contribution was in question pending certain strategic decisions on the part of AIG and its parent and no submission to the MDI had been made.

On October 14, 2003, the Company submitted a Form D filing to the MDI proposing a capital contribution of approximately \$60 million in securities from Arch Insurance Company to Arch Specialty Insurance Company, a subsidiary of AIC. In connection with this Form D filing, Arch Capital Group Inc. and Arch Insurance Company entered into a related "Keepwell Agreement" dated December 16, 2003. Under this "Keepwell Agreement", Arch Capital Group pledges to provide additional capital to AIC, not to exceed the sum of \$60,000,000 in order to assure that AIC maintains 1.) 300% of authorized control level risk based capital; and 2.) an IRIS liquidity ratio of less than 104%. The "Keepwell Agreement" will remain in full force and effect until such time as the ratio of AIC's investments in subsidiaries to its statutory surplus falls to 40% or below, or until the Company has provided additional capital to AIC totaling \$60,000,000, whichever occurs earlier. On December 19, 2003, the MDI notified the Company they had no intention of disapproving this transaction.

Effective January 1, 2003, the Company amended its 90% Quota Share Reinsurance Agreement with Arch Reinsurance Ltd., a Bermuda-based affiliate of AIC, to include AIC Program business written with inception dates or renewal dates on, or after, January 1, 2003. This change has a significant impact on the amount of written premium AIC retains, reducing the net written premium as a percentage of the gross

written premium from 40% in 2002 to a projected 35% in 2003 and 12% in 2004. The full impact of this change is not realized until 2004 since the change was not effective until treaty year 2003.

ACKNOWLEDGMENT

The assistance and cooperation extended by the officers and the employees of Arch Insurance Company during the course of this examination is hereby acknowledged and appreciated. In addition to the undersigned, Angela Campbell, CFE, Steven Koonse, CFE, and Andrew Balas, CFE, examiners for the Missouri Department of Insurance, participated in this examination. The actuarial firm of Expert Actuarial Services LLP, of Chesterfield, Missouri performed an actuarial analysis as part of this examination.

VERIFICATION

State of Missouri)
)
County of)

I, Vicki L. Denton, CFE, on my oath swear that to the best of my knowledge and belief the above examination report is true and accurate and is comprised of only facts appearing upon the books, records or other documents of the Company, its agents or other persons examined or as ascertained from the testimony of its officers or agents or other persons examined concerning its affairs and such conclusions and recommendations as the examiners find reasonably warranted from the facts.

Vicki L. Denton, CFE
Examiner-In-Charge
Missouri Department of Insurance

Sworn to and subscribed before me this _____ day of _____, 2004.

My commission expires: _____

Notary Public

SUPERVISION

The examination process has been monitored and supervised by the undersigned. The examination report and supporting workpapers have been reviewed and approved. Compliance with NAIC procedures and guidelines as contained in the Financial Condition Examiners Handbook has been confirmed.

Frederick G. Heese, CFE, CPA
Audit Manager
Missouri Department of Insurance